International Studies Quarterly (1998) **42**, 625–644

Trying to Have Your Cake and Eating It: How and Why the State System Has Created Offshore

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From modest beginnings in the wholesale financial market specializing in government debt, offshore has expanded rapidly, penetrating and then dominating an ever growing portion of international economic life. This article reflects on the relationship between offshore and the concept of state sovereignty. My argument is that far from escaping the state, offshore is intimately connected with the state system. The concepts of sovereignty and national self-determination played simultaneously an enabling and constraining role in the development of offshore. Furthermore, having "created" offshore, sovereignty and self-determination are themselves constrained and (re-)enabled in turn. Offshore therefore is not a diminution of state sovereignty but a legally defined realm marking differential levels of intensity by which states propose to apply their regulation. Such a bifurcation of juridical space represents a process by which the state is reimagining its relationship to its territory.

The article addresses a combined and complicated set of developments which have come into prominence in the past two decades. They include the rise of the offshore financial markets together with the spectacular proliferation in the number of tax havens and the growth in their significance in the world economy; a dramatic rise in the number of export-processing zones and free trade zones, from two in the early 1960s to over 800 today, providing employment directly to over a million and a half workers worldwide (McMichael, 1996). In addition, there has been a significant impact of the "flag of convenience" which dominates international maritime fleets, and the extension of the principles of "flagging out" into other spheres such as aircraft leasing. The Internet is providing opportunities for the extension of similar principles into areas such as gambling, pornography, telecommunication, and on-line merchandising (OECD, 1995). Soon shoppers will be able to avoid paying local taxes by purchasing goods in "offshore" shops using offshore coupons (*Economist,* 1997). There is even a rudimentary nonstate law (Teubner, 1993; Cutler, 1997).

These developments have attracted considerable attention in their respective area studies but rarely are they perceived as generically related. In this article I argue that, for a variety of reasons and despite considerable differences among them, these

Author's note: The author would like to thank Jason Abbott, Libby Assassi, John Agnew, Gary Burn, Angus Cameron, Randy Germaine, Richard Phillips, Susan Strange, and three anonymous referees and the editors of *ISQ* for their helpful suggestions and comments.

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Published by Blackwell Publishers, 350 Main Street, Malden, MA 02148, USA, and 108 Cowley Road, Oxford OX4 1JF, UK.

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developments are inherently related. The principle common denominator is that they have come about as states use their sovereignty, or their right to write the law, often deliberately, to create special territorial or juridical enclaves characterised by a reduction in regulations, including taxation. Discrete and uncoordinated state policies have combined to create new, intangible "shores," marking off activities or territories in which the state's regulation and taxation (but not the law) are fully or partially withheld. This has resulted in the bifurcating of the sovereign space into relative realms distinguished by degrees of regulations. I call this fledgling relative regulatory realm the realm of the offshore economy.

There is no universally agreed upon definition of offshore. The term was probably coined in reference to those "offshore" radio stations such as radio Caroline in the U.K. or the Peace station in Israel which, emulating radio Luxembourg, evaded national broadcasting restrictions by locating on vessels situated just outside the territorial waters of their respective countries. These radio stations were quite literally "off-shore." The designation was then adopted widely in intuitive recognition that an underlying similar principle was in operation in finance, shipping, manufacturing, and telecommunication. Nevertheless, "offshore" means quite different things to different people. Foreign direct investment of multinational enterprises is often labeled as offshore. For instance, an OECD study of global communication refers to foreign investment by national telecommunications carriers as "offshore" (OECD, 1995). In financial literature, offshore is often used in a more restrictive sense to describe the unregulated international financial markets or the Euromarkets. For others (e.g., Hewson, 1982), the Euromarket is only one aspect in a broad category Hewson calls the offshore financial market. Confusingly, the International Monetary Fund (IMF) and the Bank for International Settlement (BIS) consider only tax havens as Offshore Financial Centres (OFCs). But then the City of London, which does not qualify as a tax haven, is considered the hub of global offshore finance. Further, many writers consider export-processing zones and free trade zones as tax havens while others maintain that "flags of convenience," offered by countries such as Liberia, Panama, Vanuatu, Luxembourg, the Marshall Islands, Cyprus, and the like, are forms of tax havens as well.[1] The list can be supplemented by the new practice of rerouting Internet porn calls through zero-regulated countries such as Guyana and Niue.

The lack of clarity is reproduced among the growing number of dedicated journals. *Offshore Finance Canada*, for instance, publishes articles that are concerned primarily with tax havens and tax issues. In contrast, *Offshore Outlook*, an on-line journal, lists a great variety of items including international private and family trusts, multi-currency dealings, global custody, unit trusts, pensions funds, export processing, ship registration, and aircraft leasing. Due to the great variety, it may come as no surprise to learn that there are many academic doubts as to whether it is appropriate to speak of the development of an offshore economy. In many ways their doubts are valid because there are obvious differences between, say, offshore financial markets and export-processing zones. Nonetheless there are shared common grounds that transcend sectorial barriers in that offshore economic activities take place in specially designated regulatory spaces. Some of these spaces are visible territorial enclaves, others are mere "fictional" or juridical realms. It is the emergence of both types of juridical enclaves, supported and maintained by the state system, that renders offshore a political and economic development of great significance.

[1] This is the view of Peter Oppenheimer who directed the Bank of International Settlements' desk on the Euromarket during the early 1960s (see Oppenheimer, 1985).

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In describing this phenomenon as the development of an "offshore" economy, this article seeks to shift attention from the study of economic processes to the study of the nature of the regulatory realms in which economic processes take place. Specifically, I would like to point out the subtle but important distinction between offshore and, on the one hand, privatization and deregulation which have tended to apply to the entire territory of a country, and, on the other, the externalization of activities associated with transnational transactions—if by the latter we understand developments external to the very life of the state system.

In pointing out the subtle differences between these related and yet different developments, we can obtain a better understanding of the relationship between globalization and the state, a debate that has been dominated for a while now by three different schools of thought representing widely diverging opinions. The first school of thought, which is closely associated with the globalization thesis, maintains that the state is currently being "hollowed out" from within, soon to "wither away" under the pressures of the global market (Ohmae, 1990; Dendrinos, 1992). The second maintains that globalization is an episodic event, perhaps mere hype, the myopic product of the "long peace" and the end of the Cold War. In this view, associated with realists like Krasner (1994) and Jackson and James (1994) and world system theorists like Chase-Dunn (1994), there is nothing about the past two decades to warrant questioning the fundamental structures of the world, be they the system of states or the "world system" inherited from the long sixteenth century. A third interpretation suggests that the "hollowing out" of the state represents a major structural event in the life of states, and a form of accommodation to globalization as explicated by the "competition state" thesis (Strange, 1987; Cerny, 1990; Drache, 1993; Jessop, 1993; Hirsch, 1995; Palan and Abbott, 1996). In this view, this restructuring event is in itself internally contradictory and unsustainable (Lipietz, 1994; Cerny, 1995).

One of the fascinating aspects of offshore is that it offers an additional fourth perspective. The argument is that by this process of bifurcation of the sovereign space, the state system is dealing with the more mobile economic sectors by providing them with areas where government interference is less stringent. And since these more mobile elements are increasingly bracketed out of the state, the state can carry on discharging its traditional roles as if nothing had happened, thus helping to alleviate some of the tension between globalization and the state system. To be precise, in most cases states are using the tactics of sovereign bifurcation, not necessarily to isolate themselves from the economic impact of globalization—although this was probably the motive behind some of the offshore facilities, such as the Chinese Special Economic zones and the International Banking Facilities of New York and Tokyo—but as a way of providing less regulated and taxed spaces without undermining their claim to regulate and tax other areas of economic activities. In other words, offshore does not isolate the state from globalization as much as it offers a politically acceptable resolution to the tension between globalization tendencies and the state. Offshore, therefore, captures simultaneously two sets of instrumental realities. It is a case of having your cake and eating it: maintaining the state system as organizer and mediator of conflict and tension, yet removing the threat of regulation and taxation attendant with the state—all done in the name of and by the state system itself. "Offshore," therefore, can be thought of as an ingenious device reconciling two incompatible trends.

Seen in this light, offshore is an incredibly complex and fascinating development, one that bears upon not only issues of finance and trade, but also our understanding of the nature of order and change in the modern world. To begin with, it requires a reevaluation of the common perception of the relationship between state and globalization. More fundamentally, once down this road, the analysis presented here challenges conventional notions of agency and change in international affairs.

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Obviously such a wide array of topics cannot be discussed within the framework of one article, so I will concentrate instead on the strong and intimate relationship between the rise of offshore and sovereignty. Specifically, I will argue that the concepts of sovereignty and national self-determination are playing simultaneously enabling and constraining roles in the development of offshore. Furthermore, having "created" offshore, sovereignty and self-determination are themselves constrained and (re-)enabled in turn.

There are, of course, different interpretations of the nature of sovereignty and sovereign equality. Depending on which view one takes, one can come to the conclusion that sovereignty is or is not eroded. The view taken here is that it is not. In the first section I introduce a distinction between theories that view sovereignty as control over territory and those that view sovereignty as an accepted convention. From the point of view of the latter, which is a standard "constructivist" view of sovereignty as an institution, it can be demonstrated that sovereignty, or the right to write the law, is at the heart of the movement toward the creation of the offshore economy. The second section develops the argument for a definition of offshore as differential regulatory realms. The third section then traces a link between offshore and the legal precedences that made such facilities possible. The fourth section offers a brief survey of the historical development of the offshore economy.

Is Sovereignty Eroding?

Volumes have been written on the central role of new technologies of information in underpinning profound societal changes (Nordenstreng and Schiller, 1993; Castells, 1996). The accepted wisdom is that the new technologies and the attendant economic changes they are helping to bring about are eroding state sovereignty. The literature tends to equate sovereignty with what Pfannenstill (1936) long ago defined as sociological sovereignty, which is the ability of the state to steer and control economic and social activity within its territorial boundaries. Consequently, the perceived decline in the capacity of the state to steer and control economic behavior, as it did (or was supposed to have done) during the heyday of Keynesian macroeconomic policies, is interpreted as the decline of sovereignty. In effect, this literature is grounded in an assumption of a fundamental incompatibility between states as technologies of control and the new technologies of communication. As Drake notes with regard to the transborder data flows (TDFs) debate: "[F]rom the outset, the terms of discourse were framed as the unenforceability of a sovereign state's policies even within its own territory, and the subjugation of nationals to foreign decision-making" (Drake, 1993:273).[2]

The erosion thesis is open to debate on both empirical and theoretical grounds. Empirically, a number of writers point to a fact often ignored by the erosion thesis, namely that precisely those acts that have led to the apparent erosion of sovereign control are often sanctioned and enthusiastically supported by state officials (Strange, 1986; Goodman and Pauly, 1993; Helleiner, 1994; Kapstein, 1994). Empirical observations notwithstanding, there is a strong theoretical argument to suggest that the debate is grounded in an illegitimate shift from a sociological theory of sovereignty, which views the state as the de facto supreme authority in a community, to a juridical (or constructivist) theory of sovereignty which views sovereignty as a mere formal prescription (Pfannenstill, 1936:273). From a juridical perspective, decline in the capacity of the state, or, more appropriately, decline in

[2] The term *transborder data flow* (TDF) adopted by the OECD suggests an image of corporate activities unmediated by territorial control. This literature tends to place the emphasis on technology and market forces (for discussion see Drake, 1993).

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the capacity of governments to control and steer the national economy, has little or no relevance to the broader question of sovereignty.[3] Indeed, it may be argued that the erosion of sovereignty debate has hindered our understanding of the creative uses of sovereignty in the modern global political economy.

The juridical approach points out the tremendous variation in meaning of sovereignty throughout the ages. Sovereignty began its career as a spatio-territorial concept. It derives from Roman law, which was constructed on the model of the community of families and hence has a strong link with location (Fustel de Coulanges, 1955). "La patrie" stood for the land of our fathers, the land where our ancestors worshiped. The link with the land was, therefore, of a "religious" character and could not be compromised. Jean Bodin ([1576]1986) recognized that these ideas were suitable for the emerging particularistic European order, the governing assumption in Bodin's formulation being that sovereigns had moral responsibilities toward their "own" population. The sovereign was therefore legally and morally entitled to have the final say within his territory. Considering that European monarchs obtained de facto independence from the Church and the Holy Roman Emperor long before Bodin's work, many historians of political thought believe that the true significance of Bodin's formulation was the attribution of human foundation to the law (Mairet, 1997:45). His ideas established ethical foundations for a secular political order.

Bodin's theory of sovereignty legitimized a particularistic order in which polities were no longer deemed bound by universal, unchanging laws (Benn and Peters, 1959:256), but an order that evolved as a direct result of the rising power of monarchs and the bourgeoisie vis-à-vis the nobility and the Church (Ranke, 1840). Sovereignty at that period was, therefore, fundamentally a statement of independence made by the secular authorities.[4] In International Relations historiography, the belief (which has spread) that a veritable particularistic order had emerged by the end of the Thirty Years War is incorrect. Princes were not granted complete independence, nor did they aspire to such. On the contrary, European monarchs were deemed bound by natural and Christian law (Botero, 1956:63).[5] In fact, a true particularistic order, as expressed in the rising fortune of positivist international law, became predominant only in the early years of the nineteenth century (Van Ansbeck, 1976:190).

It was only in the nineteenth century that the state became the true "lord of the manor," a transformation that manifested itself in the move from sovereignty to popular sovereignty. Purportedly, an argument about the locus of sovereignty, the doctrine of popular sovereignty, first asserted by the Fronde movement in France, postulated the separation of the "people" from the body of the king. In so doing, this argument about the locus of sovereignty began to represent the nation as the constitutive principle of political authority. The significance of this new theory of sovereignty has to be seen in the broader context of the attribution of volition to an

[3] The German historical sociological school, whose ideas are represented more recently in the work of Hans Kelsen (1945), sought to overcome the irritating situation whereby the sociological and juridical conceptions of the state vary. By a clever line of argumentation they strove to consolidate the state into a unified whole and invest its socio-juridical unity with the decisionmakers. This position informs the dominant school of international relations, namely, realism. The shift from a purely juridical theory to sociological theory of sovereignty, however, introduced a number of ambiguities. As a constitutional-sociological position it naturally raises questions about effective sovereignty and control.

[4] Sovereignty was therefore practiced well in advance of its theoretical reformulation. Academics are fond of calling Jean Bodin the father of the modern concept of sovereignty. Bodin had no such illusions. He saw himself as merely decoding and grounding existing practices in a legitimate theoretical argument. His Six Livres drew extensively on biblical and Greek sources to support his contention.

[5] "The insulation of the nation-state in the matter of law enforcement," observed Cole, "is a very different thing from insulation as respect law itself. The maintenance of order on a particularistic basis requires that local interpretation of general law be final; it does not require a denial of the existence of a general law" (1948:18).

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abstraction—the nation. The nation, in other words, became an actor in world politics (Mairet, 1997:104), with the nation's aims and goals beginning to be viewed in terms of public policy. It is only since the early nineteenth century, therefore, that sovereignty came to be expressed in the dual capacity of the state to devise policies and laws, with the two normally being considered to be one and the same.

This brief historical overview suggests that juridical and sociological theories of sovereignty are not two closely related dimensions of sovereignty, but profoundly diverging interpretations of the nature of sovereignty and its political and social implications. According to the juridical view, sovereignty is essentially an ordering code which "in the hands of the lawyers is absolute in form only. They have succeeded in concocting a doctrine which appears to concede everything to the politically mighty of the earth without clearly conceding much of anything to anyone" (Cole, 1948:16). Sovereignty, therefore, is not this great mysterious engine of political control (MacIver, 1966:8). Indeed, it was only in the early nineteenth century that sovereignty became directly associated with issues of policy and control.

Proponents of the juridical theory of sovereignty hold, therefore, that since sovereignty is a formal ordering principle, a norm, it should not be invested with powers it never possessed. Although sharing the same broad principles, the fact of the matter is that the right to write the law, which is the essence of sovereign rights, has been interpreted differently in different periods and has been used in different ways. During the nineteenth century, the shift from sovereignty to popular sovereignty was mirrored by a trend toward increasing insulation of the state in law (or the rise of positivist international law) (Neff, 1990). There were, however, certain unintended dynamics in the relationship between the increasing insulation of the state in law and the internationalisation of capital felt increasingly towards the end of the nineteenth century. It is these dynamics that have contributed to an increasing use of sovereignty as a commercial asset. Particularistic political order expresses itself in differences in laws and regulations among states. Over time, transnational capital has learned to take advantage of such differential regulations among states by shifting locations between them. States have responded to increasing capital mobility in complex and varied ways, but increasingly in the past two decades certain types of states have responded by offering specifically designed zero or near-zero regulatory realms. Offshore, in that sense, is closely related to sovereignty and is due entirely to states' willingness to use their sovereign privileges to devise laws and regulations that are aimed at attracting business into "their" territory.

The emergence of an offshore economy, while often interpreted in broad brush as evidence for the "withering away of the state," should be interpreted from a constructivist point of view as a radical redrawing of sovereignty. This can be understood as a process by which traditional "meanings" of sovereignty—meanings that have attached themselves to sovereignty in the nineteenth century and include notions of national interest and civic unity—are undergoing fundamental changes and yet sovereignty, or the right to write the law, is reaffirmed as a fundamental principle of international order. The increasing use of sovereignty as a commercial asset is therefore grounded in an historical development that is not necessarily best suited to today's conditions. Although there is growing concern with the use of sovereignty as commercial asset, governments of leading states, for obvious reasons, are reluctant to open up and question such fundamental principles of international order. There is, therefore, little evidence for the decline of sovereignty: that is to say that the state versus globalization and the erosion of sovereignty debates are largely divorced from reality "on the ground." Globalization is taking place, but not at the expense of the state or sovereignty—it is taking place at the expense of popular sovereignty. On the contrary, in a very complex manner sovereignty is creating a unique regulatory space for which the designation "offshore" is the most appropriate, but since this is a development within sovereignty, it is also constrained in

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important ways by sovereignty. There is, therefore, a large element of historically specific development and accident in the evolution of offshore.

A Conceptual Definition of Offshore

The designation offshore is used in many ways, including offshore finance, offshore investment, and offshore oil drilling. The common use, nonetheless, is offshore finance or its "quintessential" (Roberts, 1994:93) manifestation, the Eurocurrency market. Although too narrow and in that sense misleading, finance does offer a useful starting point.

Financial experts lament that there is no exact definition of offshore finance. As Hewson states (1982:406), "There is no universally agreed definition of offshore financial markets and offshore banking." The failure to come up with an exact definition of offshore finance is not at all surprising, since difficulties in defining offshore finance are caused by the exclusive focus on financial matters. This leads experts to seek in vain some unique form of financial markets; whereas, in reality, offshore is not a process or a market, but a designation of the status of the regulatory realms in which certain activities take place.

Offshore finance is a category of international banking; the latter is conventionally divided into two types: (1) Eurobanking, which is business generally consisting of foreign currency denominated asset and liability operations of banks, located in a given country with banks and non-banks located inside and outside the same country; and (2) traditional foreign banking which largely consists of domestic currency denominated asset and liability operations of banks located in a given country, with banks and non-banks located in other countries (Hewson, 1982:406; for a critique see Terrell and Mills, 1985). Offshore finance is frequently used interchangeably with Eurobanking.

Eurobanking is a specialised type of intermediate finance, the exact origins of which are somewhat unclear. Difficulties in dating the origins of the Euromarket are due, in part, to a failure to distinguish between the market for dollars in Europe and the Euromarket (Kane, 1983:3; Burn, 1997). A lively market for dollars has existed in Europe since the end of the Second World War, whereas the Euromarket, which is a market unregulated by states, is believed to have emerged in 1958 (Sengupta, 1988; Burn, 1997).[6] The often heard argument is that due to the Suez Canal crisis and the ensuing run on the Sterling, the British government imposed restraints on Sterling credits to countries engaging in third-party transactions within the Sterling area and, in addition, raised the Bank rate to 7 percent. In response, British banks began actively to solicit dollar deposits to use in trade credits (Sengupta, 1988:26).[7] These transactions in dollars were then considered to be taking place not under the exchange rate regulation, reserve regulation, or any other regulations of the British state, but de facto under no regulation. In 1963, the loan market was supplemented by the Eurobond market, which consists of bonds underwritten by international banking syndicates and not subject to any country's securities laws (Park, 1982).

As Eurobanking developed and spread, it became progressively difficult to precisely define its boundaries. However, three positions have emerged in reaction

[6] There is debate as to the exact origins of the Euromarket. According to Adam Smith (1976), the first Eurodollar business was an $800,000 loan issued on 28 February 1957 by Moscow Narodny Bank, through a London merchant bank.

[7] There is a lively debate on the significance of the British action in stimulating the development of the Euromarket. Higonnet (1985:39) cites the Radcliffe report which contains a detailed description of the 1957 Sterling crisis as evidence that it was not of great significance. See also comment of Jane Sneddon Little on Higonnet's article in the same book.

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to these developments. One school of thought, exemplified by Terrell and Mills, maintains that international markets have become so integrated that "segregating a precisely defined Euromarket is neither possible nor useful" (Terrell and Mills, 1985:184). Although Terrell and Mills implictly accept a conceptual distinction between offshore financial markets and on-shore markets, they maintain that offshore banking dominates international financial transactions to such an extent that a large and growing proportion of international banking is free of regulation (Terrell and Mills, 1985:184). A study of international finance is, therefore, for all intents and purposes, a study of the offshore financial market. Others, such as Hewson, advocate replacing the term *Euromarket* with *offshore finance* on the understanding that the latter contains additional attributes (Hewson, 1982). For Hewson, the defining feature of offshore is "transactions are usually thought to be 'offshore' from the perspective of the 'host' country, even though the banks that do these operations are located onshore" (Hewson, 1982:406).

In addition to Eurobanking, offshore are cases where

- some attempt is usually made to separate the "offshore" from the "onshore" banking activities and the rest of the domestic financial system, either by exchange control, regulation, tax incentives, separate accounting procedures, etc.;
- the institutions in the market tend to be classified as nonresident for balance of payments purposes;
- transactions in these markets have a significant nonresident component. In some cases transactions are specifically restricted to nonresidents, but in others "resident access" to the market is permitted to varying degrees;
- transactions in the offshore market are primarily restricted to foreign currencies (Hewson, 1982:406).

Drawing on such views, Susan Roberts proposes a "relativist" definition of offshore finance (Roberts, 1994:93). According to this approach, although both "on-shore" and "off-shore" regulations change over time, the distinction is relevant because many states still maintain a distinction and insist that banks and other financial institutions hold two separate "books" (Hanzawa, 1991). In this broad sense, the term *offshore* thus designates the regulatory realm in which certain financial transactions take place. Offshore is not physically separated from on-shore and indeed, some types of offshore financial markets can be created quite simply "if books for foreign to foreign accounts are kept separate from books for domestic financial and capital transactions" (Hanzawa, 1991:284). The offshore finance market(s) therefore may be thought of as "fictional" or purely "juridical spaces."

The literature distinguishes among three types of offshore financial centers: the so-called spontaneous offshore sites, such as the U.K. and Hong Kong; International Banking Facilities (IBF) such as New York and Tokyo; and tax havens. According to the latest census, sixty-eight states are tax havens (Diamond, 1997). However, these three categories are "ideal types," as each offshore financial center and tax haven offers its own unique "bundle" of financial regulations. The spontaneous offshore center of the City of London is so called because, allegedly, it grew up spontaneously. London's position as the heart of the offshore financial market can be traced back to attempts by successive British governments to reestablish London as the center of global financial activities after the Second World War. Under the 1947 Exchange Control Act, which reaffirmed the 1939 Currency (Defence) Act which established exchange controls at the beginning of the Second World War, some British banks were given permission to deal in foreign currency. In December 1951, the foreign market opened in London. Dealing in Sterling, however, was still

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restricted under the 1947 Act, so while all other currencies were traded freely, Sterling remained controlled and could be sold and bought only by designated banks. Due to a deteriorating balance of trade, however, restrictions on credit were imposed in September 1957, including banning refinancing in Sterling. This then led to a paralleled expansion of overseas borrowing and lending (*Bank of England Quarterly Bulletin*, 1964). In 1958 Britain returned full convertibility for nonresidents. In that way, the Bank of England in effect walled off Sterling but allowed dealings in other currencies free of regulations. The new facilities offered by London (and Paris as well) generated interest particularly among other central banks and official institutions (Grant, 1967).[8] From 1957 there ensued a period of progressive relaxation of exchange controls, culminating in the 1979 U.K. Banking Act, the first act of the Thatcher government, which removed exchange controls. Since then London has been considered effectively an offshore financial market.

An IBF is a more stringent type of offshore market, in which companies must apply for a license to trade. The New York IBF emerged toward the end of the 1970s as the result of a prolonged and complicated battle between the U.S. Treasury, the Swiss government, and a number of Caribbean tax havens. With the active encouragement of the New York banking community, particularly Citibank and Chase, the U.S. Treasury came to the conclusion that rather than fight the onset of offshore, the United States stood to gain more by encouraging its own offshore centers (Hines and Rice, 1994). A swift volte-face took place culminating in the establishment on December 1, 1980, of the New York offshore market, the New York International Banking Facilities (IBF). In turn, the creation of the New York IBF spawned the creation of the Tokyo, spreading the effects of offshore much wider (Fehrenbach, 1966; Naylor, 1987). Meanwhile the Singaporean IBF, known as the Asian Currency market, was established in 1968 when Singapore licensed a branch of the Bank of America to set up a special international department to handle transactions of nonresidents. The Asian Currency market is a separate set of accounts in which all transactions with nonresidents are recorded. Although ACUs (Asian Currency Units) are not subject to exchange controls, the banks are required to submit detailed monthly reports of their transactions to the exchange control authority (Hodjera, 1978:223).

Tax havens present their own definition problems because today, practically every offshore center can function as a tax haven to foreign residents (for discussion see Johns, 1983; Ginsburg, 1991; Johns and Le Marchant, 1993; Hines and Rice, 1994; Palan and Abbott, 1996). Johns (1983) defines tax havens as:

> economies which have made a deliberate attempt to attract thereto international trade-oriented activities by minimization of taxes and the reduction or elimination of other restrictions on business operations, such that, within the jurisdiction of the center, aggregated economic activity is substantially geared to the special global invisible needs of external enterprises and investors. (1983:20)

Tax havens are countries with (1) little or no income or corporate tax, (2) strong bank secrecy laws, (3) good telecommunication links with global markets, and (4) public presentation as a tax haven (Hines and Rice, 1994).

These financial centers are linked: London, New York, and Tokyo serve as primary centers for worldwide clients and act as international financial intermedi-

[8] There is some controversy as to the extent by which London grew "spontaneously" (see Higonnet, 1985; Kane, 1983; Fry, 1970).

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aries for their market regions; booking centers such as Nassau and the Cayman Islands are used by international banks as the location for "shell branches" to book both Eurocurrency deposits and international loans; funding centers such as Singapore and Panama play the role of inward financial intermediaries, channeling offshore funds from outside their markets toward local uses; and collection centers like Bahrain engage primarily in outward financial intermediation (Park, 1982). Such a hierarchy is testimony to the degree of specialization and interdependence among offshore centers. Supported by their respective states and boasting slightly different packages of legislation, these centers are the platforms upon which an integrated offshore finance system had evolved. In that sense the state system itself is providing the material and legal infrastructure of offshore (Palan and Abbott, 1996).

The same principle that underpins the development of offshore finance is in evidence elsewhere. Peter M. Oppenheimer, who worked for the BIS in the early 1960s, comments on Robert Aliber's comparison of tax havens with flag of convenience: "Professor Aliber . . . attaches prime importance to the stimulus which freedom from reserve requirements, interest rate ceilings, and other regulatory restraints have given to offshore banking. And compares this freedom with that afforded by tax havens and flag of convenience. He also might have added, I think, by export processing zones which is another example of the same sort of thing" (1985:100).

That "same sort of thing" that Oppenheimer talks about is precisely what is defined here as offshore. Export Processing Zones (EPZs) and the Chinese Special Economic Zones are designated areas, largely free from host country regulations, into which companies can import raw materials or semifinished goods which they can then finish and export. Within the zone, the physical infrastructure and services necessary for manufacturing are normally provided: roads, power supplies, transport facilities, low-cost/rent buildings. In a number of cases, restrictions on foreign ownership which apply in the country as a whole are waived for foreign firms locating in the zone.

Offshore may be defined, therefore, as regulatory realms characterised by differential degrees of regulations, including taxation. It includes finance, manufacturing, and the broad development in "flagging out" into "niche industries and activities that have been targeted by the jurisdiction's administrative system, such as shipping registers, ship-chartering, aircraft-basing, film-making, property development, cross-border equipment leasing, employment companies, mining and oil production and development, and writers' royalties" (Johns and Le Marchant, 1993:27). The Internet has opened up a whole new world of offshore: there is already offshore virtual casinos provided from countries such as Costa Rica. Guyana and Niue earn considerable income from rerouting Internet porn calls. Similarly, a number of small islands are offering unregulated jurisdictions for the conduction of telecommunication (OECD, 1995), the most significant of which is the development of on-line retailing, which avoids both tax and regulation (*Economist,* 1997).

Offshore is, therefore, a significant development in the era of globalization, which so far has manifested itself in three forms:

1. Offshore can take a tangible form of territorial enclaves, normally located near airports or ports, as in the case of free trade zones.
2. Offshore can take a purely "juridical" or virtual form, as in the case of the IBFs and the "spontaneous" financial centers. Offshore in such cases is an accounting or booking device, in which certain financial or other transactions are considered "offshore" and are subject to minimal state regulation.
3. Offshore may refer to targeted permissive laws and regulations, such as financial and insurance laws, of many of the tax havens or to the shipping laws of flag of convenience. These states are conventionally called "tax havens," but

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> they serve as tax havens for only specific purposes. Permissive laws and regulations may therefore be considered specialised realms differentiated from the great body of laws and regulations of these states, which are often as restrictive and regulated as any other state. In that sense, offshore has to be distinguished from "liberal" states that have adopted permissive or libertarian laws throughout their territories.

To summarize, offshore consists of a set of juridical realms marking differential degrees of intensity, by which states apply regulations, including taxation. Offshore is legal enclaves distinguished from their "on-shore" brethren, not necessarily because of their location, but because they define a territory or a realm of activities in which states choose to withhold some or all of their regulations and taxation. In that sense, offshore signals a profound fissure in the life of the state system: it denotes nothing less than the bifurcation of the juridical space of sovereignty into mutually dependent relative spaces.

Offshore and the Law of the Sea

There is a subtle but important distinction to be made between the externalization of activities associated with the idea of transnational transactions—if by the latter we understand developments that are external to the very life of the state system—and offshore, which is presented as externalization of economic activities but in fact operates within the realm of sovereignty. How can sovereignty be divided in such a way? Why are such new "fictional" boundaries described by the spatial metaphor of offshore? To the best of my knowledge, a detailed scholarly study of the origin of the term *offshore* has never been conducted, but there are some useful hints which suggest the term is of significance.

The term *offshore* is not accidental but contains an oblique reference to a set of legal precedents and principles that inform the treatment of coastal waters, namely, the Law of the Sea. The tradition of thought that evolved with regard to the sea offers, however, a number of apparently contradictory interpretations. In Roman law, the sea belonged to all humanity and included rights to fishing. Offshore might then be interpreted, as many people assume, as the area that belongs to all humanity, a commons, which is external to state sovereignty. Intriguingly, however, the term *offshore* may have been adopted in allusion to a different understanding of the role of sovereign rights over areas adjacent to the state—an understanding that brings us back to the concept of sovereignty as discussed in the first section.

The earliest political concern with coastal waters involved the distribution of favors by rulers. These favors included exclusive rights to shallow fishing grounds and to salt deposits in tidal marshes, exemption from port or harbor dues, and unhindered transit through narrow straits (Prescott, 1975:32). Concomitantly, the Law of the Sea had to consider the strategic problems the sea has traditionally posed. Since naval operations take place in waters purportedly outside state boundaries, the danger of foreign ships approaching the shores and bombarding at will had to be averted. That meant, for security reasons, monarchs felt obliged to make claims to areas beyond the physical realms of the state, and this, in turn, led sovereigns to argue that the state's legal boundaries did not have to correspond strictly to their territorial boundaries.

In the European historical context, the emergence of a particularistic political order coincided with such claims. Historically, two conflicting trends were in evidence with regard to the sea. During the medieval ages, many seas had become more or less effectively appropriated by states, with the most notable example normally considered the republic of Venice which assumed sovereignty over the

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whole of the Adriatic Sea. The republic of Genoa advanced similar claims over the Ligurian Sea. The Scandinavian countries extended their dominions over the Baltic and the English crown claimed sovereignty over the "English Sea." The most extensive claims were put forward by Spain and Portugal which divided the great oceans between them (Fulton, 1911).

Such extensive claims were in fact abandoned by the seventeenth century, and replaced by more modest counterclaims to adjacent territorial waters (Fulton, 1911). The earliest published claim to a specific width of the coastline took place in the late medieval ages when the fourteenth-century Bartolous asserted that 100 miles was the correct distance (Prescott, 1975:24). Although this was followed for the next four centuries by a great number of unilateral declarations about the extent of territorial waters, there was no international agreement or norm until the early nineteenth century (Prescott, 1975). Coinciding, therefore, with the development of the modern state system, a more modest and yet robust principle of extraterritorial extension of state boundaries has also evolved. At the same time, the Law of the Sea has acknowledged certain limitations on sovereign claims over territorial waters and indeed has recognized that "there were jurisdictions of various kinds and for various purposes" (Fulton, 1911:3).

The Law of the Sea established, therefore, two important principles. One may be described as the principle of discontinuity between legal and physical boundaries. Crucially, while sovereignty is obviously territorial in nature, sovereign rights need not correspond to the physical space of the land. That meant that sovereign claims were no longer bound strictly by the physical boundaries of the state but could draw on theoretical argument about effective sovereignty and/or special economic rights. This principle proved to be an important idea because it opened the door for a definition of fictional or imaginary shores, the latter defined instrumentally. The term *shore*, therefore, no longer served as a description of a geographical position of an area that lies between the sea and land, but could be used in legal parlance to describe juridical boundaries. At the same time, the second principle recognizes the possibility of relative sovereign claims over certain territory. That suggests that, in reality, and contrary to the Declaration of the Rights of Man and of the Citizen of August 26, 1789, sovereignty was not indivisible, inalterable, and imprescriptible. On the contrary, it is divisible and potentially relative.

These two principles proved particularly useful in guiding modern law with regard to developments in communication and transportation technologies. "Imaginary" shore could be extended not only laterally but also vertically, so that the juridical boundaries of the state could be extended upward to an agreed upon point in the sky. This upper limit at 50,55 miles was defined as the Von Kármán line (Cohen, 1964:18). At the same time, the right of innocent passage of airplanes and other flying objects was extended to the new atmospheric "shores." The idea could be extended further and serve as the basis of definition of juridical shores in which the new "borders" are not defined in terms of an agreed upon distance from "real" shores, but in terms of the objects and processes that are considered to be "within" sovereignty. Discontinuity between physical and juridical boundaries has permitted, therefore, not only a de facto increase in the size of the territorial boundaries of the state, but also surprisingly a de facto and voluntary decrease in the size of the state. States could simply decree, either explicitly or implicitly, that certain types of transactions or objects be considered "offshore," whether or not in reality they take place within their territory.

I conclude from the above that the term *offshore* is not entirely accidental, but alludes to a well-established practice of limited sovereignty over certain territories. In the traditional sense, offshore meant limited sovereignty over areas adjacent to the state. In the modern sense, offshore means a voluntary reduction of state sovereignty (in the sociological sense as defined above) so that certain areas or

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sectors are treated as if a state has only limited sovereignty over them. In both cases, and contrary to common perception, "shore" in legal parlance does not necessarily define the limit to sovereignty, but rather defines the area in which claims of sovereignty are more complex.

The Four Stages in the Evolution of Offshore

The strong conceptual affinity linking sovereignty with offshore is becoming clear. While offshore evokes images of the high seas, of activities taking place far away from dry land, "offshore" is in fact an "in-between" juridical realm where states are able or willing to apply only a certain degree of regulation. How and why is this in-between juridical realm expanding? The question needs to be carefully addressed, for I am not arguing for some juridical determinism: there is no mysterious legal lobby that seeks to play mischievous games with our legal system. One should not lose sight of the fact that the offshore facility is exploited by identifiable private as well as public interests. Markets, as Sol Picciotto contends, cannot exist without state regulation, "since the state is essential to the creation and guaranteeing of the property rights that are traded" (Picciotto, 1992:80). But while markets need the state, the state taxes and regulates the markets. Offshore, in fact, offers an appealing facility of the state doing the first and relinquishing the second, a possibility that is clearly in the short-term interest of capital. That the facility of offshore emerges sometimes with the encouragement of the central capitalist states, and at other times through "benign neglect," is not in dispute (Johns, 1983; Strange, 1986; Ginsburg, 1991; Picciotto, 1992; Kapstein, 1994). Nonetheless, there is no evidence of coordinated activity by either capital or states, but dispersed development that gradually led to offshore.

In fact, historically offshore evolves in four closely related stages. First, an embryonic form of offshore unwittingly emerges in pragmatic resolution of the contradiction between national law and capital mobility; these embryonic forms then inform juridical innovations; at the third stage innovations are competitively emulated by other states; and eventually this emulation reaches saturation and a complex form of "race to the bottom" toward regulatory laxity begins to manifest itself. A full demonstration of each phase of every aspect in the development of offshore is far more than can be attempted in a single article. I will concentrate on a few illustrative cases.

Pragmatic Resolution of the Contradictions Between Positivist Law and Internationalization of Capital

Great Britain was one of the first countries to introduce individual income tax. It was established early on the principle of taxation of British residents on their worldwide income, but as joint-stock companies began to proliferate in the last quarter of the nineteenth century, a problem arose in relation to the tax liability of British companies whose activities took place abroad. In 1876, two cases were brought to the Exchequer court involving Calcutta Jute Mills and Cesena Sulfur mines. The court held that although their activities took place abroad, these companies were under the control of persons whose governing body was England, and were therefore liable to British taxation. The court's decision makes clear the importance of the location of investment decision, but the implications were, however, that a British company could escape potential liability to income tax on its trading if it proved that the whole of its activities, including all management and control, took place abroad. The case that set the precedence for a company to be registered in Britain, yet resident abroad, was Egyptian Delta Land and Investment Co. vs. Todd which came to court in 1929. The decision in Egyptian Delta Land,

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writes Picciotto, "created a loophole which in a sense made Britain a tax haven: foreigners could set up companies in the UK, which would not be considered UK resident under British law because they were controlled from overseas, but might be shielded from some taxation at source because they were incorporated abroad" (1992:8). Similarly, the legal convention that allowed the development of the Euromarket, namely, the decision to consider trading in nonresident currencies as not under the British regulations, was an important "non-decision" made by the Bank of England (for discussion see Higonnet, 1985; Burn, 1997).

The emergence of European tax havens is another case not so much of a resolution of a contradiction, but of an historical accident. The distinguishing feature of European tax havens like Switzerland, Luxembourg, Liechtenstein, Monaco, and the Channel Islands is that they tend to be small, anachronistic formations. Originally, these jurisdictions did not set themselves purposefully to establish laws that would attract tax evaders; rather, it was the other way around: the world around them launched on a course that has led to an unprecedented rise in taxation and regulation. These small and conservative states refused to follow suit so that in countries such as Switzerland, where tax matters were under civil and not criminal law, tax evasion was not deemed a criminal offense. Switzerland was therefore unable to cooperate with other European states in tax matters and became, together with other small states, a haven in which the rich placed their assets.

Innovations

By the early years of the twentieth century a number of countries like Switzerland, Monaco, and Lebanon were renowned as "asset havens" for the rich. Of great significance to the future development of tax havens was the Swiss Banking Law of 1934, which for the first time enshrined the principle of bank secrecy by placing it under the official protection of the penal law (Fehrenbach, 1966:73). It thus became a criminal offense for bank officials to divulge any information concerning a customer's identity, including divulging information to the Swiss government! The Swiss then extended the law so as to protect foreign nationals as well. Similarly, the diffusion of Euromarket activities gave rise to the "realization that even wider operational freedoms and business opportunities were strategically possible in targeted areas of low or zero taxes" (Johns and Le Marchant, 1993:13). This has led to what Johns and Le Marchant call a second-stage developmental process: the transformation of tax havens that were rather basic financial centers into fairly sophisticated offshore financial centers.

Broadly similar developments are in evidence with regard to export-processing zones. The first export-processing zone was established in another peripheral small European state, in Ireland, near Shannon airport. Shannon airport developed because of its geographic location as the first suitable landfall for long-distance aircraft traveling from the United States to Europe. A vibrant aviation infrastructure developed around the constant and growing international traffic. Advances in engine technology and aircraft design steadily extended flying range, and by the late 1950s it was clear that Shannon's strategic role would soon be eclipsed. This imminent and unwelcome change in Shannon's fortunes was the catalyst for the formation of the Shannon Free Airport Development Company by the Irish government in 1959. Its role was to develop an alternative basis for a continuation of air transport activity at Shannon.

The company set about its task by seeking to simultaneously and speedily develop industrial and tourism infrastructures in the region. The company began to innovate by extending the existing duty-free status to embrace the operation of manufacturing industry within a designated zone. Thus, the first free trade zone emerged. As late as 1966 there were only two export-processing zones in developing countries

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(Emadi-Coffin, 1996:73), one in India and one in Puerto Rico, but in parallel with the proliferation of the tax havens their number has dramatically increased. Today there are more than 700 Free Trade Zones of various descriptions. These export-processing zones are complemented by a more restricted type of offshore such as the Chinese Special Economic Zones, the European enterprise zones, and offshore processing trade agreements. The proliferation of EPZs is, of course, continuing as more and more developing states attempt to follow the path of export-led industrialization. While innovations of new forms of offshore facilities can sometimes be attributed to host governments' developmental policies, in other cases they are not. It seems that, in fact, the United States has played a prominent role in the growth of flags of convenience since the 1920s, when the United Fruit Co. created the Honduran registry to ensure the cheap and reliable transport of its bananas. At the same time, prohibition led to the birth of the Panamanian registry: the owners of two U.S.-flag passenger ships who wanted to serve liquor on board were permitted by the U.S. government to switch to the Panamanian flag so they could do so (Morris, 1996). The United States also developed Liberia's flag of convenience after the Second World War to provide the colony with a needed economic boost and provide the United States with a fleet of neutral ships to draw upon in the event of Soviet aggression (Morris, 1996). The United States has developed the Marshall Islands flag of convenience for similar purposes (Van Fossen, 1992).

Tom Naylor (1987) argues that many tax havens came about as a result of core countries' covert policies. There are therefore a great many reasons why states innovate with offshore facilities.

Competitive Emulation

The importance of flight capital as a potential source of deposits became increasingly evident to the big American money-center institutions during the 1960s. The consensus among U.S. financial institutions, reports Naylor, was that "US-based and US-controlled entities are badly penalized in competing for flight money with the Swiss or other foreign flight money centers over the long run" (1987:33). In Naylor's view, the critical innovation used by the major American banks to gain access to hot money was the innovation of negotiable "Certificates of Deposit" introduced by Citibank in 1961. Certificates of Deposit (CDs) are short-term negotiable instruments issued by banks with terms of maturity, mostly of up to one year. They originated as an essentially imaginative response to the constraints on New York commercial banks that were losing ground to savings banks (Harrington, 1992), and gave banks confined to the short-term money market an entry into the long-term capital market.

Forays into offshore business led American and Canadian banks to develop neighboring tax havens in the Caribbean (Naylor, 1987). Fugitive criminals introduced many of these havens to the business, while others emulated their successful brethren. As a result, the Caribbean havens developed phenomenally fast during the 1970s, with strong links to both London and New York. These emerging tax havens adopted Switzerland's bank secrecy laws, and, in many cases, new centers emerged by feeding off the collapse of a previous one, for example, Beirut taking business from Haifa, the Bahamas from Cuba, and so on. A steady supply of bank deposits from people who, for one reason or another, sought to evade inspection in their own country (usually criminals, money launderers, and tax evaders) found its way to these havens.

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Race to the Bottom

Switzerland became the benchmark and any newcomer had to up the stakes. Whereas the Swiss created the numbered account, meaning that only one or two officials in the bank know the identity of the account holder (which can very well be different from the ultimate user), Luxembourg has taken the principle a step further, allowing only one bank official to know the identity of the holder of a numbered account. In Austria the principle has been taken to its logical conclusion: under Austrian law none of the banking officials needs to know the identity of the holder; s/he is merely an untraceable number.

The race to the bottom literature tends, however, toward exaggeration. There are counter tendencies as tax havens, for instance, seek to specialize in niche markets. Some serve as a mere domicile for paper companies set up for the central collection of globally dispersed incomes, such as patent royalties or licensing fees; others specialize in investment and captive insurance and are used as financial pivots for broad international business activities. Specialization largely dictates the types (or lack) of regulation and taxation that are provided by these havens so that the proliferation of tax havens does not necessarily lead to an aggregate reduction in regulations. The latest to join, like Montesserat, Turks and Caicos, Seychelles, and the like, are known for their regulatory laxity.

Offshore, therefore, evolved in a complicated and largely uncoordinated manner. It was neither "planned" nor envisaged.

Conclusion: Ironies and Paradoxes

The particular angle by which offshore has been examined in this article, namely, sovereignty and national self-determination, reveals the incredible flexibility of the state system which is capable of withstanding as well as undergoing profound changes. Offshore is an unwittingly ingenious device: it is a juridical space in which economic transactions can be carried out with relatively little state interference; but at the same time, it is a protected space. In that sense, offshore is an instrument by which states can actively participate and shape processes of globalization. In arguing this I do not seek to imply that any one state, or the state system as a whole, either wished offshore to happen and/or has control over it. Offshore was neither envisioned nor proposed either by states or by private capital. On the contrary, it took shape over time in bits and pieces and in a series of discrete policy decisions. The manner by which this "fictional" juridical space was constructed relied heavily on the legal convention that permits states, however small and pitiful, to devise their own laws. This points out the crucial role the competitive state system plays in the extension of offshore.

State and sovereignty, therefore, play a crucial role in aiding and sustaining globalizing processes. The relationship between state and globalization, however, is not instrumental but historical and dialectical. But is it a case of having your cake and eating it? Will offshore ensure the survival of the state and the state system in the era of globalization? There are three possible future scenarios.

The first scenario suggests that offshore is a transitory phase that unintentionally accelerates the decline of the state. The clearest evidence for such a trend is in the area of finance where the distinction between offshore and on-shore is increasingly blurred. According to this view, genuine global financial markets are in existence and are, by and large, unregulated by states. A similar trend is in evidence with regard to manufacturing and trade: not only are the number and size of export-processing zones and other special economic zones increasing, but they are supplemented by a great number of bilateral trade deals that effectively sanction the externalization of manufacturing activities. Furthermore, there is evidence for a

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growing competitive contest among states that are increasingly forced to offer packages of tax breaks and other sweeteners to capital. The total annual costs of such sweeteners are estimated to be in excess of 600 billion dollars (Palan, 1998). According to this scenario, the Internet and the new information technologies pose the greatest threat to state sovereignty, and offshore simply paves the way toward an unregulated, non-state world.

The opposite scenario suggests that the trend toward offshorization has reached its zenith and may be reversed. This is not impossible, but highly improbable. As the phenomenon of tax havens spreads, there are clear indications of a counter-movement spearheaded by regional organizations such as Nafta and, particularly, the EU aided by the OECD and the BIS. Great Britain repealed a tax havens loophole in 1989, the Swiss government is now prepared to cooperate with foreign tax authorities, and the European Union is proposing to standardize financial laws throughout the community. If European regulations come into force, they will effectively undermine the Netherlands', Luxembourg's, and Britain's roles as tax havens. The trend toward deregulation in shipping through the "flag of convenience" facility is counteracted by countries like the United States which impose their regulations, including labor laws, on any vessel that wishes to dock in U.S. ports. Regulation of the Internet is also under way.

The way states are currently dealing with flag of convenience abuses may serve as a model for future handling of offshore abuses. Quite simply, if the U.S. and the EU decide, either separately or together, to place an embargo on goods produced in export-processing zones, or on financial transactions taking place by companies registered in a particular tax haven, then that particular facility is doomed. It is therefore within the powers of these large regional organizations to reverse the trend toward offshore.

A third scenario suggests that the "in-between" situation of cohabitation between offshore and on-shore will remain if not static, then at least the normal state of affairs. There will be a constant cat-and-mouse game of states and businesses innovating with new offshore types of facilities, counteracted by multilateral and bilateral responses effectively closing the loopholes. This is not a satisfactory state of affairs but, on current trends, it is the one most likely to happen.

Whatever scenario comes about, offshore demonstrates that the relationship among the system of states, sovereignty, and globalization is far more complex than is usually acknowledged.

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